THE ECONOMIC OUTLOOK GROUP

475 Wall Street
PRINCETON, NEW JERSEY 08540 Tel: 609 - 529 - 1300
www.economicoutlookgroup.com

ECONOMIC TALKING POINTS

Bernard Baumohl
Chief Global Economist

June 17, 2014

A Change in Forecast: Dark Clouds Ahead For the Economy?

For the first time in more than three years, we have alerted clients last week of an emerging threat to the current US economic expansion, one that could cause a more serious slowdown, potentially even another contraction, later this year or by mid-2015.

While many will focus on some recent upbeat economic reports on industrial production, employment, retail sales, and housing starts, our concern is based on other newly emerging factors that have raised fresh doubts about the path of the economy. We believe the chance of an adverse turn in the business cycle has increased because of the convergence of four troubling events.

(1) **The first is a dramatic deterioration in household purchasing power in the U.S.** Today's releases on consumer prices and real earnings underscores the erosion in worker pay. The cost of living has been increasing since the start of the year and jumped 0.4% last month, the fastest since February 2013. Over the past 12 months, Americans have seen retail prices climb 2.1%, a pace not seen since October 2012. (Chart 1)

What's most troubling is that wages have utterly failed to keep up with the higher cost of living. In the latest report on real (inflation-adjusted) pay, both average hourly and average weekly earnings over the year have turned negative. The result: with prices climbing faster than wages, purchasing power is collapsing. (Chart 2.)

Chart 1. Consumer prices, percent change over the past 12 months.

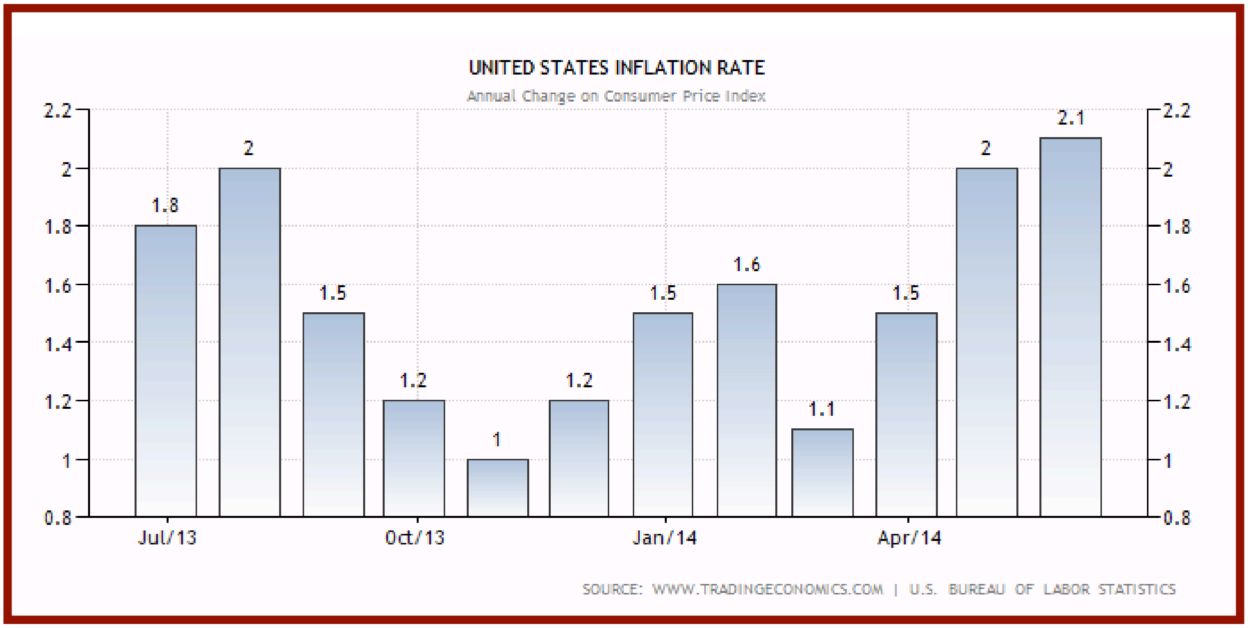
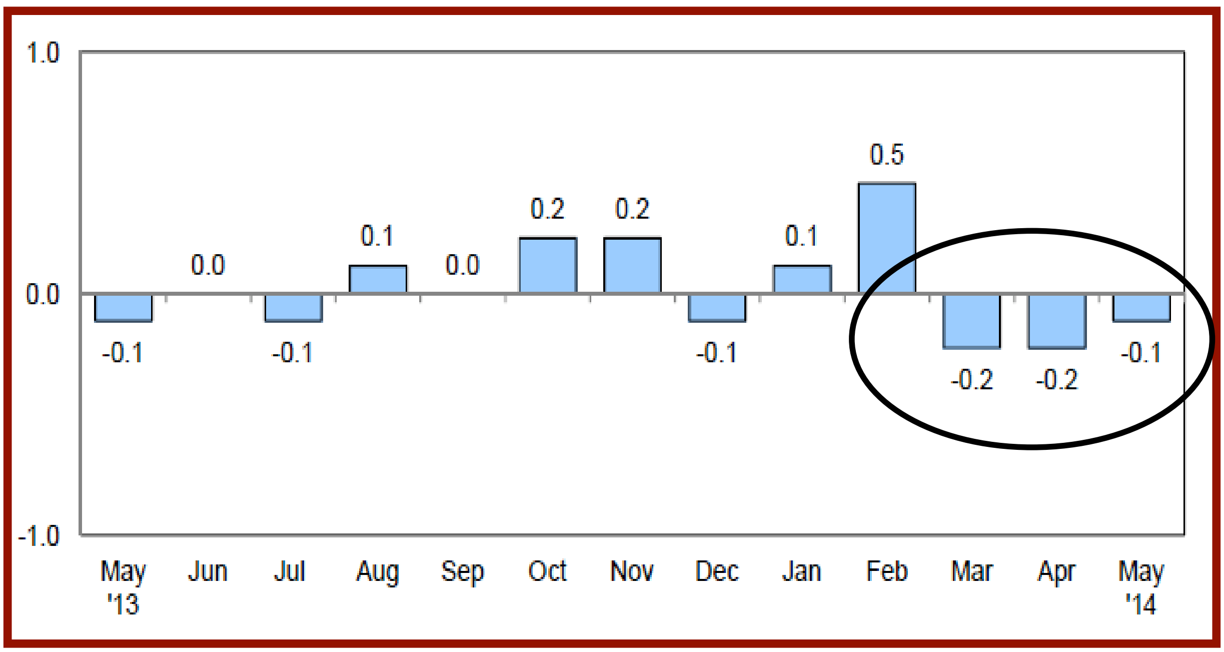
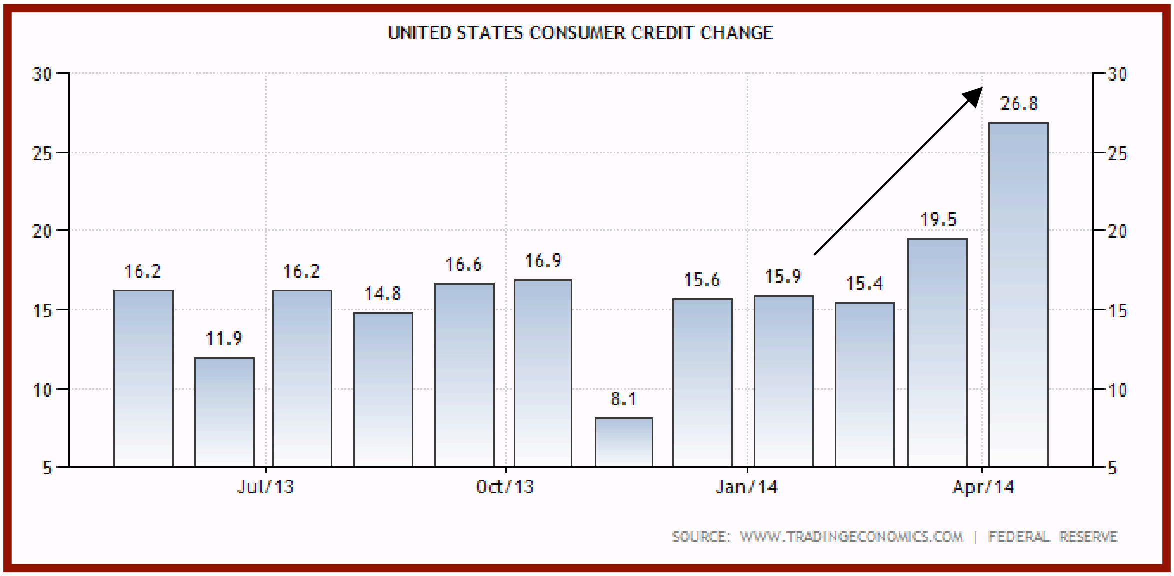


Chart 2. Annual % change in real average hourly earnings has been NEGATIVE!



(2) This leads directly to our second area of concern. Even with the erosion in purchasing power, consumers continue to ramp up spending on goods and services. Both retail sales and auto purchases have been stronger than projected. **When you have both negative real earnings AND greater consumer spending, you can be sure that households will rely more on debt to finance those expenditures.** The statistical data now points to that as well. The Federal Reserve reported that consumer credit in the most recent month (April) jumped by $26.8 billion, the largest increase in nearly three years. (Chart 3.) Particularly noteworthy is how Americans have apparently abandoned their earlier inhibitions of using plastic. Credit card debt alone climbed by $8.8 billion that month, a **12.3% annual rate, a pace we have not seen in 13 years!**

Chart 3. Change in consumer credit, monthly, $ billions



(3) **The combination of rising household debt and the expectation of higher interest rates later this year and in 2015, could strain household finances enough for them to significantly curb outlays.** Yields on the benchmark 10- yr. Treasury is already edging higher (it's up 20 basis point in just the past two weeks, to 2.64% this morning) and the market has priced a 61% chance the Federal Reserve will finally lift the fed funds rate by July 2015.

(4) **The strain on household budgets is expected to worsen further as energy prices escalate due largely to the turmoil in Iraq.** The cost of Brent and WTI oil is now at the highest level of the year and they will not retreat until tensions ease in that region of the world. The subsequent rise in gasoline prices will force households to divert more money to pay for fuel, which means less would be available for discretionary spending.

How much higher will oil prices climb? Well, clearly much depends on how the conflicts in both Iraq and the Ukraine evolve in the coming months. We made several assessments with respect to Iraq and came to the following conclusions:

Scenario A (Probability 40%) . If Sunni-led ISIS militants become so intoxicated by their victories in Mosul, Tikrit, Fallujah, and Ramadi that they are willing to advance toward Baghdad and attempt to take over the city, they will fail. The terrorist group by then will have spread themselves so thin across northern and central Iraq, they will likely be defeated as they take on the combined forces of battle-hardened fighters from Iran and Iraq and a major bombing campaign by US drones. This scenario would result in an intense but brief war, with an easing in oil prices by mid-summer.

Scenario B (Probability 60%). This involves a more protracted conflict, one that will keep oil prices elevated. Here the ISIS chooses to avoid launching a full scale attack on Baghdad and instead decides to consolidate their holdings in Iraq, in terms of cities, oil facilities (in Baiji) and weapons captured. But this scenario could prove to be far more problematic for US policymakers and detrimental to the global economy.

How so? A prolonged battle in central and northern Iraq to defeat ISIS could take on the appearance of Shia fighters systematically destroying Sunni militants and that will not sit well with Saudi Arabia, a country that has a history of financing and arming Sunni radicals in Syria, Iraq, and Pakistan. Moreover, the Saudi Kingdom is dedicated ***at all costs*** to thwart efforts by Iran to gain a stronger presence in the region. Remember, the Shia-Sunni divide has for years been essentially a war through proxies waged by Iran and Saudi Arabia.

Scenario B would thus keep oil prices elevated well above $100 a bbl. for a much longer period of time.

In addition to the bloody conflict in Iraq, events in the Ukraine add more instability to the oil markets. The latest intelligence shows Russia has ordered troops back to the Ukraine border. There are credible accounts Russia has now assembled 16,000 soldiers on the Ukraine border and placed another 22,000 in Crimea. Does the bloodlust in Iraq and the media attention it has been given provide enough cover for Vladimir Putin to make a quick grab for more of the Ukraine?

Bottom line:

Our forecast that the current expansion will continue with GDP growth in excess of 3% this year and next, is undergoing review. With household earnings lagging and real pay now negative, Americans have had to resort more to borrowing to keep up spending. But this build up in personal debt is happening as interest rates are about to head higher. At the same time, with the geopolitical pot boiling furiously, energy prices are climbing and this will place even more upward pressure on inflation in the future. Such a backdrop is not conducive to sustained period of economic growth.

As a result, the FOMC meeting underway will be a particularly difficult one because its members have to consider a set of very unpredictable and potentially harmful variables that go beyond conventional economic models. We still expect the Fed to announce another $10 billion reduction in asset purchases and see no change in their forward guidance regarding short-term interest rates. Nonethless, for reasons cited above the danger has increased the US economy could pivot from healthier growth to one that teeters close to recession in the next 6 to 18 months.

================================

© Copyright 2014 ALL RIGHTS RESERVED
THE ECONOMIC OUTLOOK GROUP, LLC
